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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1974

No. 74-1173

Estate of GEORGE T. KLEIN, Deceased,
SHIRLEY KLEIN, Personal Representative,
and SHIRLEY KLEIN,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Estate of George T. Klein, Deceased, by Shirley Klein, Personal Representative, and Shirley Klein pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in this case on December 17, 1974, reversing the decision of the United States Tax Court filed on December 5, 1973.

OPINIONS BELOW

The opinion of the United States Tax Court entering a decision for the Petitioners is reported at 61 T.C. 202 and appears in Appendix A hereto. The opinion of the

Court of Appeals is not yet reported in the official reports but appears in Appendix B hereto.

JURISDICTION

The judgment of the Court of Appeals, appearing in the Appendix hereto, was entered on December 17, 1974. No Rehearing was sought.

The jurisdiction of this Court is invoked under 28 U.S.C. §1245(1).

QUESTIONS PRESENTED

1. Is a geographically limited exclusive license of patent rights a transfer of all substantial rights to a patent permitting treatment of the transfer as a sale or exchange of a capital asset under Section 1235, Internal Revenue Code of 1954.

2. Is Treasury Regulation 1.1235-2(b)(1) invalid to the extent that it denies "sale" treatment to a geographically limited patent transfer which is otherwise recognized as a "sale" of patent rights by the Patent Act, 35 U.S.C. §261, and existing case law.

STATUTES AND REGULATION INVOLVED

The statutes involved are Section 1235 of the Internal Revenue Code of 1954, 26 U.S.C. §1235, and Section 261 of the Patent Act, 35 U.S.C. §261. The regulation involved is Treasury Regulation 1.1235-2(b)(1). Because the provisions of the statutes and regulation are lengthy, the text of the statutes and the regulation is set forth in Appendix C.

STATEMENT OF THE CASE

In 1956, George T. Klein was issued United States Letters Patent No. 2750269 covering his invention of an improvement in the process of converting organic waste into odorless organic fertilizer. In 1960, George T. Klein granted an exclusive license to Organic Compost Corporation of Pennsylvania to make, use and sell organic compost embodying improvements covered by the said Letters Patent throughout an area geographically limited to the States of Maryland, Delaware, Pennsylvania, New Jersey, New York, Connecticut, Rhode Island, Massachusetts, Vermont, New Hampshire, Maine, the District of Columbia, and a portion of the States of Virginia and West Virginia. George T. Klein retained the patent rights as to all other areas and both before and after the exclusive license arrangement with the Pennsylvania corporation licensed Organic Compost Corporation of Wisconsin (of which George T. Klein was the sole shareholder) with respect to said patent rights. The authorization of the Wisconsin corporation to make, use and sell organic compost embodying the improvement process became subject to the terms of the agreement with the Pennsylvania corporation and, in 1968, to the terms of an agreement entered into at that time with Organic Compost Corporation of Texas. The agreement with the Texas corporation was similar to the agreement with the Pennsylvania corporation except that the exclusive license granted to the Texas corporation was limited to the States of Texas, Oklahoma, New Mexico, Arizona, Louisiana, Arkansas, Kansas, Colorado and Wyoming.

The Commissioner has determined deficiencies in Petitioner's income taxes for the year 1966 in the amount of $1,829.50, 1967 in the amount of $22,921.60, and 1968 in the amount of $79,759.04. These deficiencies result

from the Commissioner's determination that royalties received pursuant to the 1960 agreement with the Pennsylvania corporation were taxable as ordinary income rather than long-term capital gains. No royalties were received under the agreement with the Texas corporation or the license to the Wisconsin corporation in the years in question.

By the terms of the agreement with the Pennsylvania corporation, Klein received royalties at graduated rates based on gross sales of organic compost by the licensee in addition to an annual minimum royalty payment of $7,500. In their joint federal income tax returns for 1966, 1967 and 1968, George T. and Shirley Klein reported the royalties received from the Pennsylvania corporation as eligible for long-term capital gain treatment relying on section 1235 of the Internal Revenue Code of 1954 and decisions under that and other sections of the Code which permit a geographically limited transfer of patent rights to be considered a sale or exchange of a capital asset held for more than six months regardless of the fact that payments of the purchase price are made in the form of royalties. *Vincent A. Marco,* 25 T.C. 544 (1955); *Edward C. Myers,* 6 T.C. 258 (1946).

The circumstances surrounding the enactment of section 1235 were set forth by this Court in *U.S. v. Zacks,* 375 U.S. 59 (1963), and in the Senate Finance Committee Report, Senate Report No. 1622, 83rd Congress, 2nd Session, 3 U.S.C. Cong. & Adm. News (1954). Both the *Zacks* decision and the Senate Committee Report recognize section 1235 was enacted as a relief measure required to overcome the obdurate position taken by the Commissioner with respect to the treatment for tax purposes of patent transfers and to provide favorable tax treatment to qualified patent holders.

In making the deficiency determination in Petitioners' income tax returns for the years 1966, 1967 and 1968, the Commissioner relies on Treasury Regulation 1.1235-2 (b) (1), issued in 1965 as an interpretive regulation. The regulation defines the term "all substantial rights to a patent" used in the statute to designate a qualifying transfer of patent rights. The portion of the regulation which is pertinent in this case excludes from the definition of all substantial rights to a patent a grant of rights to a patent which is limited geographically within the country of issuance.

The Commissioner has not disputed any other circumstance of the transfer of patent rights to the Pennsylvania corporation as qualifying as a transfer under section 1235. The only basis on which the Commissioner has sought to disqualify the transfer is the fact of its geographic limitation.

George T. Klein and Shirley Klein commenced this action in the United States Tax Court by filing a Petition on May 27, 1971. On joint motion of Petitioners and Respondent, the proceeding was submitted under Rule 30 of the Rules of Practices of the United States Tax Court and the facts were fully stipulated pursuant to said rule. On August 3, 1973, the Estate of George T. Klein, Deceased, Shirley Klein, Personal Representative, was substituted for George T. Klein as a party petitioner.

In its opinion for the Petitioners filed on December 5, 1973, the Tax Court reaffirmed its holding in *Vincent B. Rodgers,* 51 T.C. 927 (1969). The Tax Court concluded in that decision after a thorough examination of the legislative history of section 1235 and case law prior to promulgation of the regulation, that insofar as Treasury Regulation 1.1235-2(b) (1) excluded a geographically

limited transfer of patent rights from the definition of a transfer of all substantial rights to a patent, the regulation was invalid.

The Respondent appealed the decision of the Tax Court to the Court of Appeals for the Seventh Circuit. The Court of Appeals reversed the judgment of the Tax Court and remanded the cause to the Tax Court for determination in accordance with the opinion of the Court of Appeals. Petitioners believe it is significant that in its opinion, the Court of Appeals determined that the agreement with the Pennsylvania corporation "was, in effect, an assignment of the patent monopoly held by Klein" as to the geographic area subject to the exclusive license agreement. Nevertheless, the Court of Appeals concluded that Congress did not intend a geographic division and sale of patent rights to qualify as a transfer of "all substantial rights" to a patent. Relying on the decisions in *Fawick v. Commissioner,* 436 F. 2d 655 (6th Cir. 1971), and *Mros v. Commissioner,* 493 F. 2d 813 (9th Cir. 1974), involving the portion of Treasury Regulation 1.1235-2(b)(1) which excludes from the definition of a transfer of all substantial rights to a patent a grant limited to a particular field of use, the Court of Appeals for the Seventh Circuit found no difference in principle between the two portions of the regulation and upheld the validity of Treasury Regulation 1.1235-2(b)(1).

REASONS FOR GRANTING THE WRIT

I. The Court of Appeals has decided an important question of federal law which has not been but should be settled by this Court.

The taxation of patent transfers has been the subject of substantial controversy. With the enactment of section 1235, Congress intended to put an end to continued liti-

gation of certain recurring questions peculiar to patent transfers. Thus, Congress made certain specific provisions for resolution of particular questions on which the courts had taken positions contrary to that insisted upon by the Commissioner. Section 1235 assures that payments in the form of royalties will not prevent capital gains treatment for a transfer of patent rights qualifying under the section; the trade or business issue raised in the case of professional inventors was resolved by making the benefits of section 1235 available to both amateur and professional inventors; further, the section treats all proceeds of qualifying transfers as long-term capital gains without imposition of any holding period requirement.

Congress chose to designate a qualifying transfer for purposes of section 1235 as a transfer of property consisting of "all substantial rights to a patent." A patent, being an intangible asset is not technically the subject of a sale but is, instead, the subject of an assignment. In patent law cases, the distinction between an assignment of patent rights and a mere license has been important for determining the transferee's right to bring suit for infringement. The landmark case of *Waterman v. MacKenzie,* 138 U.S. 252 (1890), established the principle of the limited divisibility of patent rights for purposes of assignment of patent rights:

> "The monopoly thus granted is one entire thing, and cannot be divided into parts, except as authorized by those laws. The patentee or his assigns may, by instrument in writing, assign, grant and convey, either, 1st the whole patent, comprising the exclusive right to make, use and vend the invention throughout the United States; or, 2d, an undivided part or share of that exclusive right; or 3d, the exclusive right under the patent within and throughout a specified part of the United States." 138 U.S. at 255.

Prior to enactment of section 1235, these principles were applied with some liberality in cases involving the taxation of patent rights, *Edward C. Myers, supra.* Essentially the courts had resolved the issue of whether a "sale" of patent rights had occurred in terms of whether the transfer was in effect an assignment of monopoly rights or a mere license based on the facts and circumstances in each case. In Senate Report No. 1622, *supra,* the Senate Finance Committee indicated its approval of *Myers* and *Kronner v. U.S.,* 110 F. Supp. 730 (Ct. Cls. 1953), and indicated that its intent in choosing the term "all substantial rights" was to continue the realistic test of a sale or exchange of patent rights as developed by the courts.

Since the adoption of section 1235, the courts and the Commissioner have resorted to imposition of the all substantial rights requirement as a test of sales of patents under sections 1221 and 1231 of the Internal Revenue Code of 1954 as well as section 1235. *Redler Conveyor Co. v. Commissioner,* 303 F. 2d 567 (1st Cir. 1962); *E. I. duPont de Nemours & Co. v. U.S.,* 432 F. 2d 1052 (3rd Cir. 1970). Until the enactment of section 1253 of the Internal Revenue Code in 1969, the all substantial rights test was likewise applied to sales of franchises and transfers of trademark rights. *Joe L. Schmitt, Jr.,* 30 T.C. 322 (1958), *Estate of Gowdey v. Commissioner,* 307 F. 2d 816 (4th Cir. 1962). It is significant that section 1253 on its face recognizes that a franchise may be geographically limited.

This Court has not had an opportunity to review the application of the term "all substantial rights to a patent" in the context of transfers of patent rights under section 1235 or other sections of the Internal Revenue Code. To the extent that definition of that term has been de-

veloped with wide divergence by the courts and by the Commissioner, the inventors Congress intended to assure benefits by adoption of section 1235 remain uncertain as to the treatment their patent transfers will receive.

The Tax Court has reviewed Treasury Regulation 1.1235-2(b)(1) on four occasions, *Rodgers, supra, Fawick, supra, Mros, supra,* and this case, and continues to hold the regulation invalid.

The amount of Petitioners' liability for the tax years in question and subsequent years should this petition be denied is very substantial. Petitioners do not have the benefit of timing this cause until a conflict in the Circuit Courts of Appeals exists. Denial of the writ of certiorari Petitioners seek will only serve to prolong the controversy until such time as the position of the Tax Court is sustained by a Circuit Court of Appeals to which the question has not yet been presented. The conflict that exists between the Tax Court and the Courts of Appeals for the Sixth, Seventh and Ninth Circuits should be settled by this Court.

II. The Court of Appeals has decided a federal question in a way in conflict with an applicable decision of this Court.

In upholding Treasury Regulation 1.1235-2(b)(1) the Court of Appeals found that the regulation could not be said to be unreasonable and inconsistent with section 1235. Therefore, the court below held that the regulation must be sustained relying on this Court's decision in *Commissioner v. South Texas Lumber Co.,* 333 U.S. 496 (1948).

Petitioners contend that the recent decision of this Court in *U. S. v. Cartwright,* 411 U.S. 546 (1973), modifies that test of validity of Treasury Regulations where the regulation in question is technically consistent with the revenue statute but inconsistent with federal statutory provisions creating and regulating the subject matter. The creation and regulation of statutory patent rights is established by Title 35 of the United States Code. Section 261 of the Patent Act provides in pertinent part as follows:

> "Ownership; Assignment
>
> Subject to the provisions of this title, patents shall have the attributes of personal property.
>
> Applications for patent, patents, or any interest therein, shall be assignable in law by an instrument in writing. The applicant, patentee, or his assigns or legal representatives may in like manner grant and convey an exclusive right under his application for patent, or patents, to the whole or any specified part of the United States." 35 U.S.C. §261.

The Senate Committee Report accompanying adoption of section 1235 evidences the congressional intent to favor inventors:

> "[T]o provide an incentive to inventors to contribute to the welfare of the Nation, your committee intends, in subsection (a), to give statutory assurance to certain patent holders that the sale of a patent (whether as an 'assignment' or 'exclusive license') shall not be deemed not to constitute a 'sale or exchange' for tax purposes solely on account of the mode of payment." Senate Finance Committee Report, S. Rept. 1622, *supra,* at p. 439.

In light of the enactment of section 1235 as a relief measure, it is especially unreasonable to deny its favorable treatment to a transfer of patent rights which com-

pletely satisfies the patent law provisions as to patent assignments. As the Tax Court found in *Rodgers, supra,*

> "By its use of the phrase 'property consisting of all substantial rights to a patent,' we do not think Congress intended to import into §1235 any further or different impediments to capital gains treatment than were contained in §117 of the 1939 Code. The legislative history bears no witness to such substantial change." 51 T.C. at 931.

In this case, the Court of Appeals has found the patent transfer to be "in effect, an assignment of the patent monopoly." In upholding the validity of the regulation which denies the benefits of section 1235 to an assignment specifically authorized by the Patent Act, the decision of the Court of Appeals is in conflict with the decision of this Court in *Cartwright, supra.*

III. The Court of Appeals has rendered a decision in conflict with the decisions of other Circuit Courts of Appeals on the same matter.

In dealing with the tax treatment of patent transfers, under section 1235, the issue most frequently presented to the courts has been whether a particular transfer meets the all substantial rights requirement of section 1235. As noted earlier, this requirement has come to be imposed by the courts and the Commissioner even where a transfer of patent rights is claimed to qualify as a sale of a capital asset under other sections of the Internal Revenue Code. While the Circuit Courts of Appeals have consistently upheld Treasury Regulation 1.1235-2(b)(1) where the validity of the regulation has been squarely presented, *Fawick, supra, Mros, supra,* and this case, the tests of a transfer of all substantial rights to a patent which have

been applied are variant and sometimes irreconcilable in result.

The Sixth Circuit in *Fawick* adopted a two-pronged test initially set forth by the Third Circuit in *E. I. duPont de Nemours & Co., supra.* The Ninth Circuit in *Mros, supra,* similarly applied this two-fold test:

> "The analysis suggested by the Sixth Circuit to determine whether the taxpayer is entitled to Section 1235 benefits is a two-fold test, outlined as follows: (1) what did the taxpayer actually *give up* by the transfer; that is, was there an actual transfer of the monopoly rights in a patent; and (2) what did the taxpayer *retain* after the transfer; that is, are any substantial rights retained."

To illustrate the confusion that exists, it should be noted that in setting forth this test originally, the Third Circuit in the *E. I. duPont de Nemours & Co., supra,* decision indicated that it was concerned whether the patent transfer in question was a sale. In that case, qualification of the patent transfer under sections 1221 and 1231 of the Internal Revenue Code was in issue. The Third Circuit viewed the all substantial rights requirement in terms of whether the transaction constituted an assignment or a license and relied on its earlier decision in *Merck & Co. v. Smith,* 261 F. 2d 162 (3rd Cir. 1958). To demonstrate the incongruity in the decisions of these three circuits purporting to apply the same test, the Third Circuit in *Merck & Co., supra,* found that a transfer limited to only one of several types of sulfa drugs claimed under a generic patent was a transfer of all substantial rights and a sale for tax purposes, a result directly opposite to the holdings in *Fawick, supra,* and *Mros, supra.* Indicative of the inconsistent application of this test is the Sixth Circuit's assertion in *Fawick, supra,* that the assign-

ment v. license issue and patent law precedents are irrelevant to a determination of whether a transfer of all substantial rights to a patent has occurred for tax purposes. But the Ninth Circuit in *Mros, supra,* found patent law principles applicable and, in fact, relied on the well-established patent law principle which holds with respect to transfers limited to a field of use, that a "sale is not accomplished unless the 'whole patent' is transferred."

The Sixth Circuit also found its holding in *Fawick* supported by the decision of the First Circuit in *Redler Conveyor Company v. Commissioner, supra. Redler* involved the question as to whether royalties received under an exclusive license agreement granting rights to some but not all of the uses of the patent were personal holding company income. Relying on traditional patent law principles, the First Circuit stated:

> "The sole question is whether the agreements under which it received payments during the years in dispute are license agreements or assignments. If the agreements are licenses, the payments made under them are royalties as defined in the applicable statutes. If they are not, and the agreements are assignments, the payments are not royalties and not taxable under the statutes."

The court below has determined that a geographically limited patent transfer which is in effect an assignment of a patent monopoly nevertheless, does not constitute a transfer of all substantial rights to a patent. This result is clearly contrary to the tests applied by the Third Circuit in *duPont de Nemours & Co., supra,* and the First Circuit in *Redler Conveyor Co., supra.* To the extent that the decision of the Court of Appeals for the Seventh Circuit disregards established patent law principles on

this issue, it also conflicts with the decision of the Ninth Circuit in *Mros, supra.*

CONCLUSION

For the reasons set forth above, it is respectfully submitted that this petition for a writ of certiorari should be granted.

ROBERT M. WEISS,
Counsel for Petitioners

APPENDIX A

61 T. C. No. 36

UNITED STATES TAX COURT

ESTATE OF GEORGE T. KLEIN, DECEASED, SHIRLEY KLEIN, PERSONAL REPRESENTATIVE and SHIRLEY KLEIN, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 3533-71. Filed December 5, 1973.

Held: A 1960 "Exclusive License Agreement" which was limited geographically granted "all substantial rights" to a patent so as to qualify the proceeds for capital gains treatment under section 1235, Internal Revenue Code of 1954. *Vincent B. Rodgers,* 51 T. C. 927 (1969), followed.

Robert M. Weiss, for the petitioners.

Matthew W. Stanley, Jr., for the respondent.

OPINION

TIETJENS, *Judge:* The Commissioner determined deficiencies in petitioners' income taxes as follows:

Taxable Year	*Deficiency*
1966	$ 1,829.500
1967	22,921.60
1968	79,759.04

This case was fully stipulated pursuant to Rule 30, Tax Court Rules of Practice. The facts which we deem necessary for decision will be referred to below.

The question for decision is whether an "Exclusive License Agreement" between George T. Klein (hereafter decedent) and Organic Compost Corporation of Pennsylvania (hereafter Pennsylvania) represents a

transfer the proceeds of which qualify for capital gains treatment under section 1235.[1]

During the taxable years in issue, George T. Klein and Shirley Klein, husband and wife, resided in Milwaukee, Wisconsin. They filed joint Federal income tax returns for the taxable years ending December 31, 1966, through December 31, 1968, with the district director of internal revenue in Milwaukee, Wisconsin.

Decedent died on May 17, 1972, and his wife was duly appointed and qualified as the personal representative of his estate on May 26, 1972.

Decedent created a process which converts organic waste into odorless organic fertilizer. In 1956, he was granted United States Letter Patent No. 2750269, relating to that process of making organic compost.

In 1957, decedent formed Organic Compost Corporation of Wisconsin (hereafter Wisconsin), with its principal office located in Germantown, Wisconsin. Until his death, decedent was the president and the sole stockholder of Wisconsin.

In December 1959, Pennsylvania was formed under the laws of Pennsylvania with its principal office located in Oxford, Pennsylvania. During the taxable years in issue, decedent owned approximately twenty-four percent of the issued stock of Pennsylvania.

In 1968, Organic Compost Corporation of Texas (hereafter Texas) was formed under the laws of Texas with its principal office located in Fort Worth. During the taxable years in issue, decedent owned less than twenty-five percent of the stock of Texas.

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[1] All statutory references are to the Internal Revenue Code of 1954, unless otherwise stated.

In 1960, decedent entered into an agreement entitled "Exclusive License Agreement" with Pennsylvania. Pertinent portions of that agreement provide:

WITNESSETH THAT:

WHEREAS, Licensor is the owner of United States Letters Patent Number 2750269 relating to improvement in the process of making organic compost; and,

WHEREAS, licensee desires to acquire and licensor is willing to grant an exclusive license under said patent on the terms and conditions hereinafter set forth;

now, therefore,

in consideration of the mutual undertakings hereinafter set forth, the parties hereto agree as follows:

1. The licensor hereby grants to the licensee an exclusive license, together with the right to grant sublicenses, to make, use and sell in and throughout States of Maryland, Delaware, Pennsylvania, New Jersey, New York, Connecticut, Rhode Island, Massachusetts, Vermont, New Hampshire, Maine, all the territory in the State of Virginia North of a line extending from Williamsburg to Richmond to Covington, all the territory in the State of West Virginia North of a line extending from Marlington to Charleston to Huntington, and the District of Columbia, organic compost embodying improvements covered by the aforesaid letters patent, under and for the full life of the said patent and for the life of any improvements of said patent hereinafter granted, unless this agreement is sooner terminated under the provisions hereof.

2. The licensee hereby agrees to pay to licensor, during the life of this agreement, an annual minimum royalty of Seven Thousand, Five Hundred ($7,500.00) Dollars. In addition thereto, licensee

agrees to pay to licensor a further annual royalty, at the rates specified in the following schedule, on licensee's gross sales price of all organic compost, embodying the improvements covered by said patent, manufactured and sold by licensee:

SCHEDULE

a) 5% of the gross sales price on the first $100,000.00

b) 6% of the gross sales price on the second $100,000.00

c) 7% of the gross sales price on the third $100,000.00

d) 10% of the gross sales price on each succeeding $100,000.00

Licensee's gross sales price shall mean the net price after deducting cash discounts allowed by licensee.

3. All royalty payments due under paragraph 2 of this agreement shall be payable semi-annually on or before June 30 and December 31 of each year, commencing in the year 1961.

4. Licensee shall keep true and correct records from which all royalties payable under this agreement, and the dates of accrual thereof, may readily be determined, which said records shall be available for inspection by licensor or his accredited representatives at all reasonable times.

5. The licensee shall have the right to bring and maintain suit under the said patent against infringers thereof in its own name and/or the name of the licensor, and to make settlement with infringers; provided that the costs and expenses of any such suit shall be borne and paid licensee and it is further agreed that any and all sums which may be received in any such suit and/or settlement, whether by judgment or otherwise, shall be the sole and exclusive

property of the licensee and licensor shall have no interest therein.

6. The licensee hereby covenants and agrees that during the life of this agreement it will diligently manufacture and sell organic compost, embodying the improvements covered by said patent, and will exert its best efforts to create a demand therefor.

7. The licensor hereby stipulates that he has good title to the aforesaid patent and the right to grant the exclusive license hereby granted to the licensee.

8. In the event either party shall at any time neglect, fail or refuse to keep or perform any of the conditions or covenants to be kept or performed by it under the provisions hereof, then the other party may, at its election, serve on the party in default written notice of intention to terminate this agreement and specifying the default. If the party in default shall not cure the default so specified within 30 days thereafter, then the other party may terminate this agreement forthwith by serving on the party in default written notice of its election so to do; provided, however, that termination of this agreement shall not relieve licensee from paying the full royalties herein provided which have accrued prior to the effective date of such termination. Failure by either party to terminate for any breach of the other party shall not be construed as a waiver of the right so to do for any continuation of said breach or for any subsequent breach of the same or other provisions of this agreement.

9. Any notice hereunder must be given in writing and may be given by registered letter. Any such notice shall be deemed to have been given when such registered letter, properly addressed, is mailed. If any such notice is given otherwise than by registered letter, it shall be decided to have been given when delivered. If any such notice is to be given to licensor it shall be addressed to licensor at his office, at

Germantown, Wisconsin; if given to licensee it shall be addressed to licensee at its address hereinbefore stated. Either party hereto may at any time designate any other address in place of those given above.

10. In the event licensee becomes insolvent, or commits any act of bankruptcy, or any order for compulsory liquidation of licensee is made by any competent court, all rights granted to it and all obligations owing it hereunder shall, at the election of the licensor, immediately terminate, without prejudice to any right, action or remedy that licensor may have for recovery of any royalties due it hereunder prior to the effective date of such termination.

11. This agreement shall be binding upon the parties hereto and shall enure to the benefit of the successors and assigns of licensee and the heirs, executors, administrators and assigns of licensor, except that licensor's personal obligations hereunder shall not be assignable.

The deficiencies in issue in this case result entirely from the royalty payments received by decedent pursuant to that license agreement with Pennsylvania. During the years in issue, Pennsylvania and Wisconsin were the only firms producing the patented product.

In 1968, decedent entered into an agreement entitled "Exclusive License Agreement" with Texas. That agreement was similar to decedent's agreement with Pennsylvania, but, whereas the Pennsylvania license was limited to certain eastern states, the Texas license was limited to the states of Texas, Oklahoma, New Mexico, Arizona, Louisiana, Arkansas, Kansas, Colorado, and Wyoming. Decedent's initial receipt of royalties under the Texas agreement occurred after the taxable years in issue.

At all times pertinent to this case, Wisconsin has had authority, pursuant to an arrangement with decedent and

comparable to that granted to Pennsylvania and Texas, to make, use, and sell organic compost embodying decedent's patented process in certain Midwestern states. The rights of Wisconsin have been subject to the terms of the agreements with Pennsylvania and Texas.

In December 1969, decedent entered into a second "Exclusive License Agreement" with Pennsylvania. Under this agreement, Pennsylvania's territorial license was expanded to include the entire United States. Also in December, 1969, Pennsylvania entered into sublicensing agreements with Wisconsin and Texas.

Just prior to May 3, 1971, 4,000 shares of Pennsylvania were outstanding, and stockholders' equity in Pennsylvania totaled $600,000. On that date, as part of a transaction qualifying under section 351, decedent executed an "Assignment of Patent," whereby he assigned to Pennsylvania his entire interest in Letters Patent Number 2750269. In exchange, decedent received 8,146 newly issued shares of Pennsylvania stock with a book value of $150 per share, a total of $1,221,900. Pennsylvania placed a book value of $1,221,967 on the patent. Pertinent portions of that agreement provide:

ASSIGNMENT OF PATENT

Assignment made as of this 3rd day of May 1971, by GEORGE T. KLEIN, Glendale, Wisconsin, Assignor, to ORGANIC COMPOST CORPORATION of Pennsylvania, Assignee.

WHEREAS, Letters Patent of the United States for the processing of organic matter have been issued to Assignor, which Letters Patent are numbered A2750269 and dated June 12, 1956, and

WHEREAS, pursuant to contracts dated February 13, 1960, and May 9, 1968, Assignor granted to Assignee and Organic Compost Corporation of Texas, respectively, exclusive licenses to manufacture, use and sell organic compost under said patent in certain specified territories, and Assignor is the sole owner of such patent and all rights thereunder except for said two exclusive licenses.

WHEREAS, Assignee desires to acquire the entire interest of the Assignor in said patent and improvements,

NOW, THEREFORE, for valuable consideration, receipt whereof is hereby acknowledged, the Assignor hereby assigns to the Assignee, its successors and assigns, all of his interest in such process and in the Letters Patent issued therefor, such interest to be held to the full end of the term for which such Letters Patent or any reissues, renewals or extensions thereof are or may be granted. Assignor covenants that no royalties have accrued from the period commencing July 1, 1970, to the date of this assignment, under the exclusive license agreements aforementioned.

The Assignor agrees to execute any instruments and to perform any acts which may be necessary to carry this assignment into full effect.

The parties acknowledge that the sole consideration for the assignment of this patent is the issuance of certain capital stock of the Assignee to the Assignor, no other consideration being due and payable.

Also on May 3, 1971, Articles of Merger were entered into by Wisconsin, Pennsylvania, and Texas, pursuant to which Texas and Pennsylvania were merged into Wisconsin on June 30, 1971.

The organic compost embodying decedent's patented process and produced by Wisconsin, Texas, and Pennsyl-

vania is marketed by several national store chains and is usable throughout the United States without geographic limitation.

The Commissioner determined that royalties received pursuant to the 1960 agreement with Pennsylvania were taxable as ordinary income rather than long-term capital gains. The Commissioner relies on section 1.1235-2(b) (1) (i), Income Tax Regulations, which states that "a grant of rights to a patent — (i) which is limited geographically within the country of issuance" is not a grant of "all substantial rights" so as to qualify the proceeds for capital gains treatment under section 1235.

In *Vincent B. Rodgers,* 51 T.C. 927 (1969), acq. in result only I.R.B. 1973-11, 5, we examined the legislative history of section 1235 and numerous cases involving transfers of rights limited to certain geographical areas and concluded that regulation 1.1235-2(b) (1) (i) was invalid. We see no reason to review that legislative history and those cases to which we gave "most thoughtful consideration" in *Rodgers, supra* at 930.

In *Thomas L. Fawick,* 52 T.C. 104 (1969), reversed 436 F.2d 655 (C.A. 6, 1971), we relied on *Rodgers* and its approval of *William S. Rouverol,* 42 T.C. 186 (1964), and held invalid regulation 1.1235-2(b) (1) (iii), which excludes from the benefits of section 1235 a grant of rights "in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant." We do not believe that the reversal of *Fawick* by the Sixth Circuit affects our holding in *Rodgers,* for *Rodgers* involved geographical limitations and regulation 1.1235-2(b) (1) (i) rather than field of use limitations and regulation 1.1235-2(b) (1) (iii). See *Donald C. MacDonald,* 55 T.C. 840, 858, footnote 2 (1971).

The Commissioner argues that, even if we do not follow his regulations, we should hold that the 1960 grant to Pennsylvania was not intended to transfer all substantial rights to the patent. He argues that decedent's "Assignment of Patent" to Pennsylvania in 1971 indicated that, despite the transactions in 1960, 1968, and 1969, decedent had retained rights worth more than $1,200,000. In effect, the Commissioner asks us to use the 1971 transaction to hold that, despite the language of the 1960 agreement,[2] decedent did not intend to transfer all substantial rights to the patent.

Since the 1960 agreement was limited geographically, decedent could enter into other licensing arrangements for other geographical areas without casting doubt on the intent of the parties to the 1960 agreement. Decedent entered into such an arrangement with Texas in 1968. Decedent did not purport to grant rights encompassing the entire United States until he entered into the 1969 agreement, which is not in issue. Any questions raised by the 1971 transaction would seem to concern that 1969 transaction rather than the 1960 transaction.

The fully stipulated record provides little information concerning the 1971 agreement. The "Assignment of Patent" states that decedent was "the sole owner of such patent and all rights thereunder except for * * * two exclusive licenses" granted in 1960 and 1968 to Pennsylvania and Texas. Because the 1971 assignment is referred to as a part of a section 351 transaction, we hesitate to conclude that decedent received $1,200,000 for his rights. In the 1971 agreement, decedent apparently relinquished any right to royalties, the value of which may be included

[2] The Commissioner does not argue that the 1960 agreement contains language by which decedent reserved any substantial rights in the patent other than that language expressing the geographical limitations.

in the $1,200,000. We are in no position to determine the relationship between the 1960, 1968, 1969, and 1971 agreements, the value of the consideration in 1971, or the value of rights other than royalty rights relinquished in 1971.

The Commissioner relies heavily on two cases, *Redler Conveyor Company* v. *Commissioner,* 303 F.2d 567 (C.A. 1, 1962), affirming a Memorandum Opinion of the Court, and *Allied Chemical Corporation* v. *United States,* 370 F.2d 697 (C.A. 2, 1967), neither of which we consider controlling. In *Redler,* licensing agreements were explicitly cancelled and reconstructed. The Court said (303 F.2d at 569), "If the [earlier] agreements were actually assignments, there would be no call, indeed no basis, for this roundabout maneuver, for * * * [the assignee] already was the owner of the patents by assignment." Because we do not believe that the 1960 agreement was in fact affected by the 1971 transaction, the reasoning in *Redler* does not control our decision.[3]

In *Allied Chemical,* the licensing agreement contained specific reservations, including the right to grant a non-exclusive license in the same field of use to a specified party and the right to compel the original licensee to sub-license anyone designated by the licensor. Having examined these and other reservations and having determined that they represented substantial rights, the Court said (370 F.2d at 700) that the licensor's plans to sell the patent to the licensee three years after the execution of the

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[3] We also note that in *Redler,* in the paragraph following the statement quoted above, the Court said (303 F. 2d at 569), "More importantly, however, and indeed basically, * * * [the earlier] agreements do not purport to transfer either entire or undivided interests in the patents but instead only segregated rights to some but not all of the uses of the patents."

license indicated "that the parties did not intend the * * * license to be a sale, and that they believed that valuable and desirable rights of control had been withheld from * * * [the licensee] in that license." The Court's reasoning is not applicable to decedent's transactions, for, unlike decedent's 1960 agreement with Pennsylvania, the *Allied Chemical* license contained explicit reservations which were in fact capable of disposition and which were proved valuable by later plans for a sale. We do not find similar reservations in the 1960 agreement, and we cannot conclude that the 1971 transaction involved the disposition of any intended reservations.

Accordingly, we conclude that the 1960 agreement was a grant of all substantial rights to sublicense, make, use, and sell the patent in a limited geographical area. The proceeds of such a grant qualify for capital gains treatment under section 1235.

Decision will be entered for the petitioners.

APPENDIX B

DECISION OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

(Title Omitted)

Argued November 4, 1974—Decided December 17, 1974

Before MARIS,* CUMMINGS and PELL, *Circuit Judges.*

MARIS, *Circuit Judge.* This is an appeal by the Commissioner of Internal Revenue from a decision of the Tax Court determining the income tax liability of George T. and Shirley Klein[1] for the years 1966, 1967 and 1968. The facts were stipulated and may be summarized as follows:

In 1957 George T. Klein organized Organic Compost Corporation of Wisconsin, with its principal office in Germantown, Wisconsin. Until his death in 1972, Klein was president and sole stockholder of the Wisconsin corporation which was given the authority to make, use and sell organic compost embodying an improved process for which Klein held United States Patent No. 2750269, issued to him in 1956. In December 1959, Organic Compost Corporation of Pennsylvania was formed under the laws of Pennsylvania with its principal office in Oxford, Pennsylvania. In the years 1966, 1967 and 1968, Klein owned 24% of the issued stock of the Pennsylvania corporation.

In 1960 Klein entered into an agreement with the Pennsylvania corporation which was, in effect, an assignment of the patent monopoly held by Klein but

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* Of the Third Circuit, sitting by designation.

[1] Shirley Klein, the widow of George T. Klein, is a party to this suit as personal representative of his estate and in her own right, having filed joint tax returns with her late husband.

only as to certain specified eastern states and the District of Columbia. Klein retained the patent rights as to all other areas.[2] Under the terms of the agreement with the Pennsylvania corporation the licensee received the exclusive right to make, use and sell organic compost embodying the patented process for the life of the patent, the right to grant sublicenses and the right to bring and maintain suits against infringers in the licensee's own name. The licensor was to receive an annual minimum royalty of $7,500.00 and a percentage, increasing as the dollar volume of sales increased, of the licensee's gross sales of all organic compost embodying the patented process. The licensee agreed to keep records and to make them available for the licensor's inspection. The licensor retained the right to terminate the agreement in the event of the licensee's insolvency, the commission of an act of bankruptcy or the making of an order for compulsory liquidation. The treatment for tax purposes of the royalties received by Klein in the three years in question, pursuant to his agreement with the Pennsylvania corporation, is the subject of the present controversy.

In 1968 Organic Compost Corporation of Texas was formed. Klein was a less-than-25% stockholder. In the same year Klein and the Texas corporation entered into an exclusive license agreement which transferred to the Texas corporation the exclusive right to make, use and sell organic compost embodying Klein's patented process in the limited area of eight southern and central states. Royalties under the agreement with the Texas corpora-

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[2] The Wisconsin corporation continued to produce the patented product subject to the terms of Klein's agreement with the Pennsylvania corporation and subject later to the terms of an agreement with a Texas corporation hereinafter described.

tion were received after the taxable years in issue and are not here involved.

A second agreement by Klein with Organic Compost Corporation of Pennsylvania was entered into in December 1969, expanding the Pennsylvania corporation's territorial license to include the entire United States. The Pennsylvania corporation then entered into sublicensing agreements with the Wisconsin and Texas corporations. On May 3, 1971, Klein assigned to the Pennsylvania corporation his entire interest in Patent No. 2750269, valued by the Pennsylvania corporation at $1,221,967. In exchange, Klein received 8,146 newly issued shares of stock of the Pennsylvania corporation with a book value of $150 per share, the total book value of the 8,146 shares being $1,221,900. Just prior to this transaction, 4,000 shares of stock of the Pennsylvania corporation were outstanding. On the same date, articles of merger were entered into by the three corporations and on June 30, 1971 the Texas and Pennsylvania corporations were merged into the Wisconsin corporation.

In their joint federal income tax returns for 1966, 1967 and 1968, George T. and Shirley Klein reported royalties received from the Pennsylvania corporation in those years as long-term capital gain, claiming eligibility for such favorable tax treatment under §1235 of the Internal Revenue Code of 1954. The Commissioner, also relying on §1235 as interpreted by Treas. Reg. 1.1235-2(b)(1)(i), as amended, determined that the royalties received pursuant to the 1960 agreement with the Pennsylvania corporation were taxable as ordinary income and he assessed deficiences for the three years totalling $104,510.14. The Kleins filed a petition in the United States Tax Court for redetermination of the deficiencies. The Tax Court, following its earlier decision in *Rodgers v. Commissioner*,

1969, 51 T.C. 927, held that the petitioners were entitled under §1235 to capital gains treatment and that to the extent that Treas. Reg. 1.1235-2 indicated the contrary, it was invalid. 61 T.C. 332. The Commissioner thereupon took the appeal to this court which is now before us.

Section 1235(a) of the Internal Revenue Code of 1954 provides:

"§ 1235. *Sale or exchange of patents*

"(a) *General.* — A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are —

"(1) payable periodically over a period generally coterminous with the transferee's use of the patent, or

"(2) contingent on the productivity, use, or disposition of the property transferred."

Section 1.1235-2 of the Treasury Regulations, as amended by T.D. 6852, October 1, 1965, provides in pertinent part:

"§ 1.1235-2 *Definition of terms*

"(b) *All substantial rights to a patent.* (1) The term 'all substantial rights to a patent' means all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The term 'all substantial rights to a patent' does not include a grant of rights to a patent —

"(i) Which is limited geographically within the country of issuance;

. . .

"(iii) Which grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant;

"(c) *Undivided interest.* A person owns an 'undivided interest' in all substantial rights to a patent when he owns the same fractional share of each and every substantial right to the patent. It does not include, for example, . . . a license limited geographically, . . ."

The sole issue which this appeal presents is whether the transfer of rights to his patent in a limited geographical area which Klein made to the Pennsylvania corporation in 1960 was a transfer of "all substantial rights" to the patent, within the meaning of §1235 which would entitle him to the right under that section to treat the transaction as a sale of a capital asset as he did in his 1966, 1967 and 1968 income tax returns. The Tax Court held that it was such a transfer and that the provisions of Treasury Regulation 1.1235-2 which indicated the contrary were invalid. We conclude that the Tax Court erred in so holding, and that the Treasury Regulation is valid and correctly defines the term "all substantial rights to a patent" as used in §1235 of the Revenue Act and that it supports the Commissioner's deficiency determination.

Prior to the enactment of §1235 in the Internal Revenue Code of 1954, §117 of the Internal Revenue Code of 1939 provided the criteria for the treatment as capital gain of amounts received upon the transfer of patent rights. Under subsection (a)(4) of that section the

determinative question was merely whether a "sale or exchange" had taken place. Patent law specifically authorizes the assignment of a patent or of any interest therein or the grant of exclusive rights thereunder to the whole or any part of the United States, 35 U.S.C. §261. Under §117 (a) (4) royalties based on the use of transferred patent rights had been treated as capital gains for income tax purposes. *Myers v. Commissioner,* 1946, 6 T.C. 258; *Kronner v. United States,* Ct. Cl. 1953, 110 F. Supp. 730; *United States v. Carruthers,* 9 Cir. 1955, 219 F. 2d 21. And it was so held in the case of a transfer of patent rights limited to a particular geographical area. *Marco v. Commissioner,* 1955, 25 T.C. 544. The Commissioner, however, had announced in 1950 in Mimeograph 6490, 1950-1 CB 9, that if in the case of a transfer of patent rights payment was to be measured by royalties based on the production, sale or use of the property transferred or payable periodically over the period of the transferee's use of the property, he would regard the royalties thus paid as ordinary income and not capital gain. It was, in part, to settle the question thus raised that §1235 of the 1954 Code was enacted. As we have seen, paragraphs (1) and (2) of §1235(a) deal with this precise problem by providing that the payment of the purchase price in the form of such a periodic or contingent royalty shall not affect the legal nature of such a transaction as a sale or exchange of a capital asset.

Section 1235(a) went further, however, to provide, as we have seen, that the transfer of patent rights shall be considered a sale or exchange of a capital asset only if "all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights" are included in the transfer. In *Rodgers v. Commis-*

sioner, 1969, 51 T.C. 927, the Tax Court took the view that this language of §1235 was not intended to exclude from capital gains treatment a transfer of patent rights limited geographically, and it followed and applied that decision in the present case. We cannot agree with this conclusion.

The use of the word "substantial" is doubtless in recognition of the rule applied in *Allen v. Werner,* 5 Cir. 1951, 190 F. 2d 840; *Allied Chemical Corp. v. United States,* 2 Cir. 1967, 370 F. 2d 697, and similar cases, that the retention by the transfer of minor rights under the patent shall not affect the character of a transfer as a sale entitled to capital gains treatment. But we think that the statutory requirement that the "substantial rights" transferred shall be "all" of them, even in the case of the transfer of an undivided interest in them, indicates a Congressional intention that the transfer of a part of the patent rights, divided off from the rest by a limitation on their use or the geographical area of their exercise, shall not be deemed a sale or exchange of a capital asset. In reaching this conclusion we have been mindful of the canon that the words of a statute, and this includes a revenue act, should be given their ordinary everyday meaning. *Crane v. Commissioner,* 1947, 331 U.S. 1, 6; *Malat v. Riddell,* 1966, 383 U.S. 569, 570.

We are fortified in our conclusion by the legislative history of §1235. In the Senate Committee Report on the Code it is stated:

> "By 'undivided interest' a part of each property right represented by the patent (constituting a fractional share of the whole patent) is meant (and not, for example, a lesser interest such as a right to income, or a license limited geographically, or a license

> which conveys some, but not all, of the claims or uses covered by the patent)."[3]

In thus stating that transfers of undivided interests which are included within the definition of the section are not to be confused with transfers of patent rights limited to specific uses or geographical areas the Senate Finance Committee indicated, we think, that such limited transfers were not intended to be included within the parameters of §1235.

By T.D. 6852, approved October 1, 1965, the Secretary of the Treasury amended Treas. Reg. §1.1235-2, which defines "all substantial rights to a patent" as used in §1235 of the 1954 Code, by adding to subsection (b) the following language, *inter alia:*

> "The term 'all substantial rights to a patent' does not include a grant of rights to a patent —
>
> "(i) Which is limited geographically within the country of issuance;
>
> "(iii) Which grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; . . ." 1965-2 CB, p. 289.

The Secretary has broad authority under §7805(a) of the Internal Revenue Code of 1954 to promulgate reasonable regulations implementing the provisions of the revenue laws. The regulations may, of course, be amended from time to time when the Secretary deems it appropriate, as, for example, when it appears from the decisions of the courts that provisions of the laws may be

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[3] S. Rep. No. 1622, 83d Cong., 2d Sess., 1954 U.S. Code, Cong. & Adm. News, p. 5082.

so ambiguous as to require further implementation or interpretation. Such regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes". *Commissioner v. South Texas Lumber Co.*, 1948, 333 U.S. 496, 501. Here our independent inquiry into the language and history of §1235 has led us to the conclusion that transfers of patent rights limited to a geographical area were not intended by Congress to be included with the statutory term "all substantial rights to a patent", the transfer of which might give rise to a capital gain. We, therefore, cannot say that §1.1235-2 of the Regulations as amended by T.D. 6852 is in this regard unreasonable or inconsistent with §1235 of the Code.

We need only add that our conclusion is supported by recent decisions of the Courts of Appeals for the Sixth and Ninth Circuits, *Fawick v. Commissioner,* 6 Cir. 1971, 436 F. 2d 655, and *Mros v. Commissioner,* 9 Cir. 1974, 493 F. 2d 813. In each of these decisions subsection (b) (1) (iii) of Regulation 1.1235-2, as amended, was upheld over the Tax Court's decision of invalidity. It is true that clause (iii) relating to use division was involved in those cases whereas here we are dealing with clause (i) relating to geographical division. But we see no difference in principle between the two with respect to the problem with which we are here concerned.

REVERSED AND REMANDED.

A true Copy:
Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

APPENDIX C

Title 25 U.S.C.

Section 1235. SALE OR EXCHANGE OF PATENTS.

(a) General — A transfer (other than by gift, inheritance, or devise) of property consisting of of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are —

(1) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) contingent on the productivity, use, or disposition of the property transferred.

(b) "Holder" Defined — For purposes of this section, the term "holder" means —

(1) any individual whose efforts created such property, or

(2) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither —

(A) the employer of such creator, nor

(B) related to such creator (within the meaning of subsection (d)).

(c) Effective Date — This section shall be applicable with regard to any amounts received, or payments made, pursuant to a transfer described in subsection (a) in any taxable year to which this subtitle applies, regardless of the taxable year in which such transfer occurred.

(d) Related Persons — Subsection (a) shall not apply to any transfer, directly or indirectly, between persons

specified within any one of the paragraphs of section 267(b); except that, in applying section 267(b) and (c) for purposes of this section —

(1) the phrase "25 percent or more" shall be substituted for the phrase "more than 50 percent" each place it appears in section 267(b), and

(2) paragraph (4) of section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants.

Title 35 U.S.C.

Section 261. Ownership — Assignment.

Subject to the provisions of this title [§1 et seq. of this title], patents shall have the attributes of personal property.

Applications for patent, patents, or any interest therein, shall be assignable in law by an instrument in writing. The applicant, patentee, or his assigns or legal representatives may in like manner grant and convey an exclusive right under his application for patent, or patents, to the whole or any specified part of the United States.

A certificate of acknowledgment under the hand and official seal of a person authorized to administer oaths within the United States, or, in a foreign country, of a diplomatic or consular officer of the United States or an officer authorized to administer oaths whose authority is proved by a certificate of a diplomatic or consular officer of the United States, shall be prima facie evidence of the execution of an assignment, grant or conveyance of a patent or application for patent.

An assignment, grant or conveyance shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the Patent Office within three months from its date or prior to the date of such subsequent purchase or mortgage.

Treasury Regulation
§1.1235-2 Definition of terms.

(b) *All substantial rights to a patent.*

(1) The term "all substantial rights to a patent" means all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The term "all substantial rights to a patent" does not include a grant of rights to a patent —

(i) Which is limited geographically within the country of issuance;

(ii) Which is limited in duration by the terms of the agreement to a period less than the remaining life of the patent;

(iii) Which grants right to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; or

(iv) Which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-1173

SHIRLEY KLEIN, ETC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The sole question presented by the petition is whether the grant of an exclusive license to certain patent rights within a limited geographical area was a transfer of "all substantial rights to a patent" within the meaning of Section 1235(a) of the Internal Revenue Code of 1954, so that the royalty payments under the license agreement qualified for long-term capital gains treatment.

The pertinent facts are as follows: In 1956, George T. Klein[1] ("George") obtained a patent relating to a process for converting organic waste into fertilizer (Pet. App. A 16; Pet. App. B 27). Four years later, George entered into an agreement with Organic Compost Corporation of Pennsylvania, granting that company the exclusive rights to manufacture, sell, and use the patented product in all or parts of 13 eastern states

[1]George T. Klein is now deceased. His wife, Shirley Klein, is the petitioner in her capacity as executrix of his estate and in a personal capacity because she filed joint income tax returns with her husband for the years at issue.

and the District of Columbia (Pet. App. A 17-20; Pet. App. B 27-28). Under the agreement, George was to receive a minimum annual royalty of $7,500, plus additional royalties equal to a percentage of gross sales of organic compost (Pet. App. A 17-18; Pet. App. B 28).

For the years 1966 through 1968, George reported the royalty receipts under the agreement as long-term capital gain under Section 1235 of the Code. That provision permits a transfer of "all substantial rights to a patent or an undivided interest therein" by a "holder" to be treated as a sale or exchange of a capital asset held for more than six months, whether or not the transaction would otherwise qualify for such treatment.

On audit, the Commissioner determined that the income from the agreement was taxable to George at ordinary income rates. He based this determination upon Section 1.1235-2(b)(1)(i) of the Treasury Regulations, which provides that the transfer of patent rights within a geographically limited area is neither a transfer of "all substantial rights to a patent" nor a transfer of "an undivided interest" in all such substantial patent rights within the meaning of Section 1235 (Pet. App. A 23). The Tax Court concluded that the Treasury Regulation upon which the Commissioner relied was invalid, and held that the transaction qualified for long-term capital gain tax treatment under Section 1235 (Pet. App. A 15-26). The court of appeals reversed and remanded, upholding the Regulations (Pet. App. B 27-35).

1. Section 1235(a) of the Code gives inventors and certain other patent holders long-term capital gain treatment on the transfer of "property consisting of all substantial rights to a patent, or an undivided interest therein." By making long-term capital gain treatment available even though the consideration for

the transfer may be based on productivity or use of the patent, Congress intended to resolve judicial and administrative uncertainties which had arisen with respect to the taxation of royalty-type payments in patent licensing arrangements. S. Rep. No. 1622, 83d Cong., 2d Sess., 113-114, 438-441 (1954); see *United States* v. *Zacks*, 375 U.S. 59, 62-63.

However, the threshold requirement of Section 1235 is that the transfer encompass "all substantial rights to a patent" or "an undivided interest therein." In defining these terms, the pertinent Treasury Regulations under Section 1235 provide that the term "all substantial rights to a patent" includes "all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent * * * are transferred" and specifically exclude from such definition four categories of limited transfers: (1) grants "limited geographically within the country of issuance"; (2) grants "limited in duration * * * to a period less than the remaining life of the patent"; (3) grants "in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant"; and (4) grants of "less than all the claims or inventions covered by the patent which exist and have value at the time of the grant." Treasury Regulations, Section 1.1235-2(b)(1). Section 1.1235-2 (c) of the Regulations further provides that none of such limited transfers of patent rights constitutes a transfer of an "'undivided interest' in all substantial rights to a patent."

Here, it is undisputed that petitioner's transfer of patent rights to Organic Compost Corporation did not qualify for Section 1235 treatment under the Treasury Regulations. His transfer was limited to the rights to exploit the patent only within 13 states and the District of Columbia, and the rights he retained to exploit the patent in other parts of the country had substantial value.

Petitioner argues (Pet. 7) that the Regulations are invalid on the ground that Congress intended Section 1235 treatment to apply to all patent transfers, including those transfers of geographically limited patent rights which would qualify as assignments of patent rights, rather than mere licenses, under general patent law principles. See *Waterman* v. *Mackenzie*, 138 U.S. 252. Although this patent law principle has been deemed relevant to the question whether a transfer of a limited or divided interest in a patent might qualify as a "sale or exchange" under Code provisions other than Section 1235,[2] petitioner's contention that such a limited transfer of patent rights also qualified under Section 1235 is at odds with the "all substantial rights" qualification of that provision, as well as the clear expression of legislative intent by the Senate Finance Committee at the time of its enactment (S. Rep. No. 1622, *supra*, at 439). The Committee Report stated (*ibid.*):

> By "undivided interest" a part of each property right represented by the patent (constituting a fractional share of the whole patent) is meant (and not, for example, a *lesser interest* such as a right to income, or a *license limited geographically*, or a license which conveys some, but not all, of the claims or uses covered by the patent). [Emphasis added.]

This statement sets forth the Committee's understanding of the statutory term "undivided interest." However, it applies with equal force to the term "all substantial rights." The Committee would not have cited examples of transfers which would not qualify as transfers of an "undivided interest" in all substantial patent rights if it intended that those transfers would have qualified for Section 1235 treatment in any event as transfers of "all substantial rights to a patent."

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[2]See, *e.g.*, *E.I. duPont de Nemours and Co.* v. *United States*, 432 F.2d 1052 (C.A. 3); *Merck & Co.* v. *Smith*, 261 F.2d 162 (C.A. 3); and *Redler Conveyor Co.* v. *Commissioner*, 303 F.2d 567 (C.A. 1). Although petitioner urges (Pet. 12-13) that these cases conflict with the decision below, none of them involved the claim that a patent transfer qualified under Section 1235.

2. As petitioner concedes (Pet. 11), the decision below is in accord with the other courts of appeals. See *Fawick* v. *Commissioner*, 436 F.2d 655 (C.A. 6), reversing 52 T.C. 104, and *Mros* v. *Commissioner*, 493 F.2d 813 (C.A. 9), reversing *per curiam*, P-H Memo T.C., par. 71,123.[3] While those cases involved transfers of patents within limited fields of use, they upheld the validity of the same Regulations at issue here. The court of appeals in the present case similarly correctly sustained those Regulations, which find direct support in the terms of the statute and the legislative history with respect to patent transfers of limited geographical use. See, *e.g.*, *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

MAY 1975.

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[3]The Ninth Circuit noted in *Mros* that the portion of the Regulations dealing with transfers of patent rights within limited fields of use is itself consistent with the general principles of patent law (see *Redler Conveyor Co.* v. *Commissioner*, *supra*) as well as with the language and legislative history of Section 1235. However, the court there did not hold, or even suggest, that a transfer which would qualify as an assignment under *Waterman* v. *Mackenzie*, *supra*, would also necessarily qualify as a transfer of "all substantial rights to a patent" under Section 1235. Thus, contrary to petitioner's contention (Pet. 13-14), the decision below does not conflict with *Mros*.